ANZ Research

NZ OCR Call Change

19 January 2022

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Bottom line

- **We have changed our OCR call, and now forecast the OCR to be lifted in steady 25bp steps to a peak of 3% by April 2023.**
- While inflationary global supply-side disruptions are ongoing, it's domestic inflation pressures, and in particular the ongoing tightness in labour supply, that explain most of our change in view. Although we're still finalising the numbers, we expect upward surprises for the RBNZ in the upcoming labour market and CPI releases.
- Importantly, our updated view is not based on a belief that growth will be going gangbusters. The housing market appears to be coming to a very sudden stop; households are facing significant cost-of-living stresses and have subdued confidence; a shortage of workers and materials is hampering production; and Omicron is knocking on our door. But the reality of a prolonged negative supply side shock is that even modest growth can stretch resources and cause inflation. The trade-offs are unpleasant and there's no way around that.
- We've talked for some time about the fact that there's a decent risk the OCR won't get to even 2% before something derails the hiking cycle, and that continues to be our view. In particular, global asset prices could be vulnerable as the US Federal Reserve makes its more hawkish pivot. But such developments are inherently unforecastable, and our central forecast assumes no dramatic events.
- Another factor that could see the OCR stop short of our forecast is that broader financial conditions could do a lot of the work. Domestic credit conditions have already tightened abruptly. Global long-end yields are rising quickly, dragging local yields with them. The exchange rate could jump if global investors decide New Zealand's yields are attractive. The RBNZ should and will take all these factors into consideration when deciding how high the OCR needs to go.
- Uncertainty about the outlook is currently extreme, and no one's forecasts should be taken as gospel. While we see the balance of risks as skewed to the downside, they are not one-sided. If, for example, key global central banks start to lose inflation-targeting credibility, COVID-related supply-side disruptions worsen in China and fail to improve elsewhere, or climate change policy and/or impacts kick in meaningfully, inflation could prove even harder to rein in.
- Given the current level of house prices and household debt, an OCR of 3% might be seen as having too high a growth cost to even contemplate. The fact is, however, that globally, prolonged strong monetary and fiscal stimulus in response to what turned out to be a net negative supply shock has unleashed the inflation dragon. Central banks now have to do what's needed to bring inflation down, painful as that may be. When it comes down to it, the ability to do that unpopular task is the reason central banks were made independent in the first place. But the risk of a hard landing is very real, particularly given that the lags inherent in monetary policy effectiveness make precision steering very challenging.
- For the past 20 years, investors and other risk-takers have gotten used to thinking of central banks as their friends who have their back; that weak growth or wobbly markets mean lower interest rates. This time, it's highly conditional love. It's all about inflation now.

Oops

Central banks globally have given themselves a big job to do.

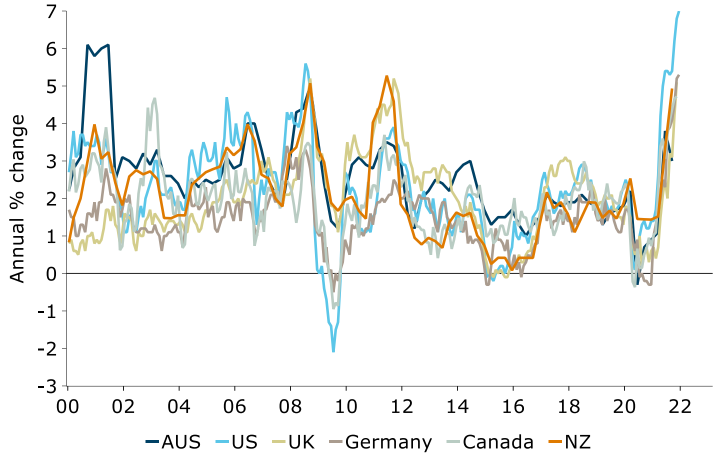
Hindsight is a wonderful thing. When COVID-19 first hit, central banks and most every other forecaster out there (including us) assumed it represented a persistent hit to confidence and broader demand, and a temporary disruption to the supply side of the global economy. The appropriate policy response was therefore seen to be to throw the kitchen sink at it, in terms of both fiscal and monetary policy. With policy rates up against the zero bound, that meant 'creative' monetary policy, including vast quantities of quantitative easing, massively expanding the money supply.

Over time, it has become evident that COVID in fact has been a series of short-lived shocks to demand, including a very resource-hungry switch from services to goods (particularly with fiscal policy back-filling the income hole from lockdowns). On the other hand, the negative shock to supply, including, crucially, labour supply, has been very persistent and is likely to have a long way to run yet.

That's a much more inflationary cocktail. Fortunately the RBNZ was much quicker than most to recognise the way the wind was blowing, winding up its QE purchases very neatly mid last year, with two hikes now under the belt already, and a lot more priced in. The market U-turn associated with the latter was a little hairy in terms of illiquid and volatile moves, but we got through it. Other central banks (of which the Fed is most important), are only kicking off that manoeuvre now. It's going to be compelling viewing, with probably a fair bit of audience participation, willing or not.

The policy mistake was very understandable, given the last global pandemic was a century ago. But with hindsight, monetary policy globally has been far too stimulatory for far too long. Hyped-up demand has hit severely constrained supply, resulting in strong and rising inflation in many countries (figure 1). It's looking less transitory by the day as inflation expectations rise and wage growth lifts. Prompt, aggressive action is now required by central banks to shore up their inflation-targeting credibility. Inflation, when it comes to the crunch, is central banks' #1 monetary policy target, with all others (full employment, avoiding unnecessarily volatility) essentially nice-to-haves that crept into mandates when inflation seemed so well tamed.

Figure 1. Global CPI inflation



Source: ABS, BLS, Stats NZ, ONS, DESTATIS, StatCan, NBS, Macrobond, ANZ Research

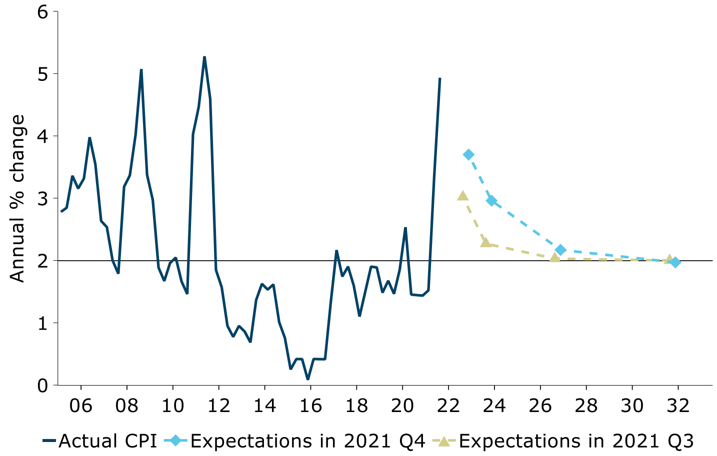
The NZ inflation outlook

For the first time in a long while, imported inflation is becoming a persistent driver of above-target inflation. Indeed, tradables inflation is looking like it'll be considerably stronger than the RBNZ's (and our) forecast. But it isn't just imported inflation driving things. The sheer degree of capacity stretch in the labour market is likely to drive a more-persistent rise in non-tradables inflation, even as the housing market looks like it's peaked.

We'll crunch the numbers once the final indicators come in, but Q4's inflation print is looking like it'll be probably be closer to 6% (or higher) than the 5.5% we've pencilled in. And inflation will probably rise yet further in coming quarters, with global and domestic drivers taking longer to rein in than anticipated.

And that's not even accounting for the imminent arrival of Omicron in New Zealand. The international experience shows that when it does land on our shores, Omicron will cause an intense (albeit short) period of chaos, disruption and yet more price pressures. While that may be a one-off spike in inflation, it's actually a pretty risky thing when inflation expectations have been steadily drifting higher (even if they're still anchored at the long-end – figure 2).

Figure 2. Inflation expectations



Source: Stats NZ, RBNZ, Macrobond, ANZ Research

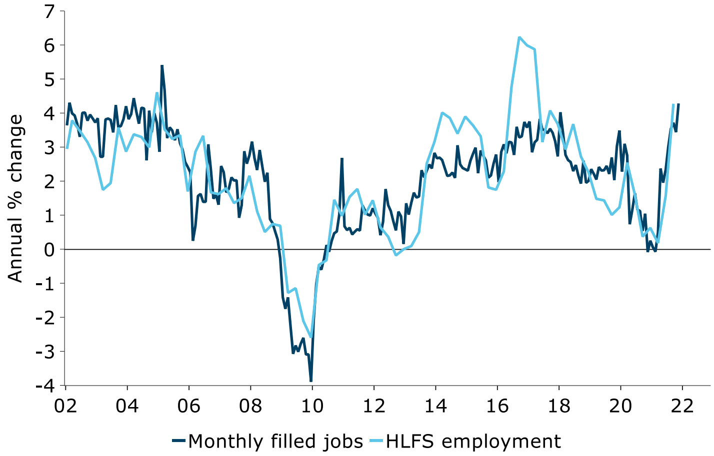
Suffice to say, the RBNZ has work to do to defend its inflation mandate from this inflation surge. Monetary policy takes time to flow through the economy and impact inflation – so don't expect the inflation pressure in the economy to ease any time soon.

The labour market

It's worth delving deeper into the state of the local labour market, as this is the main reason we think inflation is going to be persistent and require more policy tightening to rein in.

It's become increasingly clear that the current labour market is not consistent with low and stable inflation – and things will only intensify from here. Hiring surged in November (figure 3), despite our initial expectation that the Delta outbreak would cause jobs growth to stall in Q4, and unemployment to rise 0.1ppts to 3.5%. At face value, this data implies a roughly 3% unemployment rate could be possible in Q4 – and if that happened, an unemployment rate with a 2-handle could be imminent. That might sound outlandish, but measures of capacity stretch in the labour market currently meet that definition. And the labour market will likely keep tightening over early 2022 at least, with forward-looking indicators of labour demand (including employment intentions and job vacancies) still all looking solid.

Figure 3. Filled jobs and employment growth



Source: Stats NZ, Macrobond, ANZ Research

The labour market appears to have considerably more momentum than the RBNZ initially expected back in November. In the November MPS, unemployment was expected to trough at 3.2% in Q4, before steadily rising back to 4.1% in 2024. The risk is firmly that unemployment drops below our current forecast – which already has unemployment falling to just 3% this year! Overall, it's a labour market characterised by a massive mismatch between labour supply and demand, with firms having to raise wage offers in order to entice workers into the labour force from inactivity, or poach employees from their competitors. That's going to be a key driver of larger-than-usual wage rises, on top of the cost-of-living adjustments that workers will demand as inflation surges.

Gotta do what you gotta do

Assuming no abrupt developments such as a sharp re-pricing of risk globally (which we consider a very real risk, albeit an unforecastable one), we now believe the RBNZ will need to keep on hiking right on through our previous forecast of 2%. We now see a peak in the OCR of 3%, with the RBNZ raising in steady 25bp steps to get there, which would take until April next year.

An OCR at 3% might raise eyebrows. But it's half the current rate of inflation and well below household inflation expectations, currently running at over 5.5%. Thought about in 'real' terms, then, an OCR of 3% is very modest. And while a 100bp upward revision to our forecast OCR endpoint might seem large, the fact is, a 1% upward surprise to CPI inflation would hardly surprise us at all! But all that is of course cold comfort to people with massive mortgages to service, particularly if the value of their house is going backwards.

It's important to note that we are not forecasting more OCR hikes because we think the New Zealand economy has a lot more upside growth surprises left in it. On the contrary, we expect growth to be fairly insipid for a number of reasons:

- Anecdotally, the housing market has come to a sudden stop, due to a policy shock to credit availability and sharply higher mortgage rates. Higher house prices are most certainly not good news for all, but they do tend to spur spending, particularly on durables.
- Higher mortgage rates will also directly reduce discretionary spending by increasing debt-servicing costs.
- Supply-side constraints, not least labour shortages, are not growth-friendly. A 2-handle on unemployment would be awesome news for those who are able to grasp new opportunities, but it does suggest that there are

plenty of firms that would like to be producing and doing more but are constrained by a lack of workers.

- Omicron is on our doorstep. Our baseline assumption is a couple of months of pandemonium on both the demand and supply side of the economy. Indeed, the hit to some firms in the likes of the hospitality sector may prove to be the last straw, particularly if fiscal support is more limited than in lockdown scenarios. It's going to hit growth, but it's not going to be deflationary, that's for sure.

All of these things will dampen growth. But given the speed limit of the economy is so hampered at the moment, it's not clear that without further tightening these developments would be enough to open up a disinflationary negative output gap, ie lead to firms having spare capacity that they then price more competitively to try to employ.

The good news is that tight labour supply implies a pretty low unemployment rate throughout. But GDP growth could be pretty unimpressive through this adjustment. In that context, there are likely to be calls for the RBNZ to ease up. But the fact is, as long as the economy is trying to grow faster than it can, both boom-bust and inflationary risks will be worsening, and that's not good in the long run.

No more "bad news is good news"

It's worth highlighting that this implies a potential paradigm shift in how we (and markets) may (or should) interpret upcoming economic data flow. compared to the past decade or so. Inflation, inflation expectations, and indicators for labour market tightness should carry their usual signal (if it's tight, price it right). However, unimpressive activity indicators in this highly economy may reflect capacity constraints as much as they do waning demand, and that's not the way we're used to thinking about things.

That is, over the past decade or so, a weak GDP print (for example) would typically be interpreted (rightly) as indicating spare capacity opening up, and therefore downside for interest rates. But now it could just be reflecting the fact that there is no more labour/hours/overtime/capital left in the economy to bump up activity, and not necessarily indicate a lot of disinflationary pressure.

In other words, economic activity may well stagnate, but the appropriate monetary response may still be to hike. The RBNZ's judgements on the output gap are going to be both more fraught and more important than ever. Indicators of capacity constraints and costs out of business surveys (particularly for labour) will be key in this regard, as opposed to activity indicators *per se*.

Risks to our view

Uncertainty around any forecast is extreme at the moment, for obvious reasons. The answer to most any "But couldn't *x* happen?" challenge is probably "Yes, it absolutely could."

Previously we have stated that the RBNZ would be doing well to get the OCR as far as 2% by August. That actually remains our view, despite the significant upgrade to our "all going well" central forecast.

There are several things that could mean that the OCR doesn't in the end need to go as high as 3%, or even 2%.

1. An abrupt global risk re-pricing

With central banks globally now belatedly recognising the magnitude of the inflation threat, markets need to adjust to 'No more Mr Nice Guy'. As discussed above, it is no longer a given that downside surprises or risks to activity and employment will be met with central bank largesse. That's a very different environment for risk-taking of all kinds.

Pricing of risk has been historically low for a very long time, and has even deliberately suppressed by central banks in some cases (eg the US Federal Reserve buying 'junk' bonds). Asset prices of all flavours are elevated relative to fundamentals. There's undeniably been a boom; there's correspondingly undeniably a risk of a bust as the extreme monetary stimulus unwinds. It's entirely unforecastable in terms of magnitude or timing, but no less real for that.

2. Broader financial conditions do the OCR's work for it

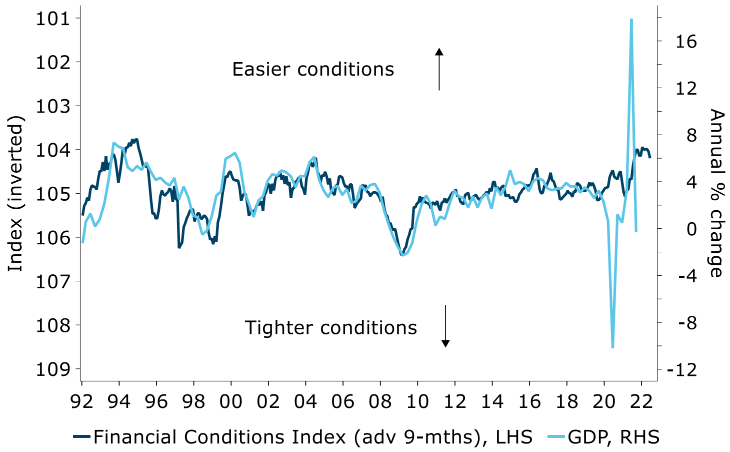
There is a lot more to financial conditions than just the Official Cash Rate and expectations thereof.

A Financial Conditions Index (FCI) tries to capture this by including "things that make it easy to borrow", with weights calibrated to match GDP growth nine months later.

Inputs into the ANZ FCI include mortgage rates (25%), the trade-weighted index adjusted for the terms of trade (20%), house price growth (20%), equity index growth (5%), credit spreads (10%), surveyed lending standards (10%), and private sector credit growth and as share of GDP (10% together).

Figure 4 below shows how easy financial conditions have been since COVID-19 hit in early 2020 – indeed, the easiest conditions since the mid-1990s.[1] While COVID volatility has meant the index hasn't matched GDP closely in the last couple of years, that's no reason to think financial conditions matter any less than previously for the growth outlook.

Figure 4. ANZ NZ Financial Conditions Index



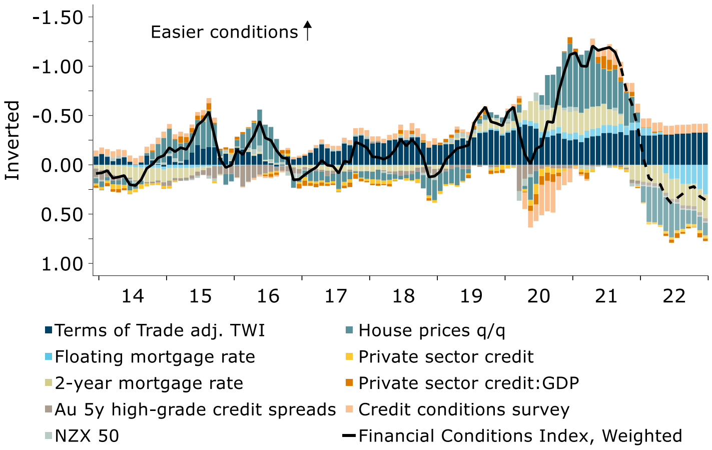
Source: Stats NZ, RBNZ, S&P, REINZ, Bloomberg, Macrobond, ANZ Research

Figure 5 below breaks the index down into its component parts, and adds in our forecasts for GDP, house prices, mortgage rates and the terms of trade and leaving everything else steady (in practice, bank lending standards have tightened abruptly since 1 December and credit growth is declining as well). It shows that financial conditions have actually already tightened a lot as mortgage rates have risen significantly, and quarterly house price inflation eased somewhat.

[1] The data is to the end of September, since the terms of trade and GDP for Q4 are not available yet.

And from about now, most everything flips to a headwind. If the terms-of-trade-adjusted exchange rate were to jump, it'd be a clean sweep (assuming the anecdotes about credit availability are eventually reflected in the RBNZ survey data). Our forecasts (including our new OCR track via mortgage rates), imply financial conditions tighter than they were pre-COVID. But given the job ahead to get inflation down, that's exactly what you would expect to forecast.

Figure 5. Contributions to ANZ NZ FCI, including ANZ forecasts for house prices, mortgage rates, GDP and the terms of trade



Source: Stats NZ, RBNZ, S&P, REINZ, Bloomberg, Macrobond, ANZ Research

However, the tightening in credit conditions caused by the introduction of the Credit Contracts and Consumer Finance Act (CCCFA) is well worth keeping an eye on. The legislation may be tweaked, but in the meantime, it appears to be a significant headwind for mortgage lending and thus the housing market. We already have a modest fall in house prices built into our forecasts, but if it were to turn into a rout, it could be much more difficult for the RBNZ to keep hiking.

3. Has the global inflation regime switched?

The risks around our 3% OCR call are not all to the downside.

In our view it's risky to assume things will return to the "normal" that prevailed 2009-2019, of inflation dead in the water pretty much throughout the business cycle. Globalisation is being rethought, China's demographic dividend has turned into an invoice, and climate change mitigation and impacts are going to be highly inflationary, and possibly a lot sooner than 'one day' (eg energy prices need to rise substantially).

Even if we did return to those days, the resolution of global supply-side challenges feels a long way off. China has not been seriously disrupted by COVID since early 2020, but that is changing fast, heralding a new round of headaches for global supply chains. Queues of ships on the US West Coast are lengthening again, and estimates of when shipping will return to normal keep getting pushed out. Omicron is causing short-term labour supply issues everywhere. Commodity prices are elevated and energy prices keep going up.

If markets start to question central banks' willingness or ability to rein in inflation in a timely fashion (eg if they misjudge the supply side of things, or if political pressure starts to come to bear as tightening starts to hurt) then globally, inflation expectations could start to rise and make the job even harder, requiring even more tightening.

What about that 50 pointer?

If the labour and inflation data come in as hot this month as we suspect, the market is likely to once more mull over the chances of a 50bp hike, this time at the February Monetary Policy Statement. As in November, it's possible, but unlikely, in our view.

- The RBNZ has made it clear that 25bp moves are the preference unless the risks are looking extremely one-sided. Inflation risks are to the upside; growth risks are to the downside, as they were in November.
- A 50bp hike would create unnecessary volatility. A similar impact could be achieved with a 25bp hike and a more aggressive forward track. As we've already seen, this is a very powerful way to withdraw stimulus without actually moving the OCR all at once. Case in point: 2-year mortgage rates have risen around 170bp from their lows, while the OCR has lifted only 50bps.
- As discussed earlier, financial conditions have already tightened markedly.

Overall, there are benefits to a 50bp hike, mainly in terms of showing that the RBNZ means business, but there are also potential costs and risks – particularly if it isn't fully priced, which it is unlikely to be given the RBNZ's earlier comments on the matter. Our judgement is that on net the small benefits do not justify the actual and potential cost.

Market implications

Our new, higher OCR forecast has upside implications for our wider interest rate forecasts, with market pricing slightly below what we now expect. Markets are pricing in an OCR of around 2¼% by the end of the year (versus our pick of 2.5%) and around 2½% by mid-2023 (versus our pick of 3%).

With long-end rates still driven in large part by global factors, we expect the short end to be impacted more. Bank bill rates typically lead the cycle, and are likely to peak a little above 3% just before the OCR gets there. From there they are expected to stabilise, and don't really have scope to move back below 3% unless or until markets start to anticipate an eventual easing. As the cycle matures they will lead the OCR lower, but we aren't yet forecasting an unwind of rate hikes, so are assuming bill rates remain above 3% over most of 2023.

Long-end rates and bond yields are still expected to follow US yields higher. Geographic spreads between New Zealand and the US (and Australia) have narrowed of late as Fed rate hike expectations have lifted, catching up on what has been priced in locally. However, our new, higher OCR forecasts suggest that geographic spreads will start to widen again as markets contemplate the NZ/US cash rate spread widening from its current level of 0.50% to 1.00%, with the RBNZ delivering seven 25bp hikes over 2022 and the Fed on track to deliver "just" five.

With inflation pressures still building rather than retreating, we think it's far too early to be thinking about inverted yield curves, and we expect NZ 10-year bond yields to gravitate towards 3½% as the year goes on.

Our full updated interest rate forecasts will be published later this week.

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Meet the team

We welcome your questions and feedback. Click here for more information about our team.

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